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TAGS: CH ECON EFIN PGOV PREL
SUBJECT: (SBU) SHANGHAI FINANCIAL SECTOR SEES CHINESE INVESTMENT AS KEY TO RECOVERY

¶1. (SBU) Summary. China 's stimulus program emphasizes capital investment, particularly in railways, subways, roads, and airports, say a variety of Shanghai financial sector professionals. Shanghai has been quick to seek support for previously rejected World Expo and other projects. At the same time, our interlocutors suggested that some thought is being given to spreading investment to inland and rural China. Bank lending will be key to the stimulus, suggested several bankers. However, the People's Bank of China (PBOC) is also concerned that excessive credit growth could lead to inflation. The United States was blamed for the financial crisis, and potential trade protectionism was cited as an aggravating factor. U.S. banks may emerge from the crisis to find the China market less welcoming. End summary.

¶2. (U) This is the first of two reports based on Beijing Finatt's February 19-20 meetings in Shanghai. This first report covers macroeconomic issues, and the second covers financial service sector trends.

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Stimulus Package Focuses on Capital Investment
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¶3. (SBU) China 's stimulus program needs to emphasize investment, since only investment can make up for falling exports, Lian Ping, chief economist of Shanghai-based Bank of Communications, one of China's top five banks, told the Finatt delegation. Of the "three horses" that power the Chinese economic "cart" (san1 ma2 che1), said Lian, exports are falling, consumption is maintaining its share, and therefore investment must make up the difference. Lian explained that this is the same approach used with success during the Asian Financial Crisis. Ding Guorong, chairman of Shenyin & Wanguo Securities, one of China's largest securities firms, said that in his optimistic scenario, the stimulus program will bolster the Chinese economy for 12 months, until exports rebound again in
¶2010.

¶4. (SBU) Our interlocutors agreed that the stimulus targets railways, subways, roads, and airports--which they explained have the greatest potential for bolstering economic growth. Steve Lee, CEO of HSBC Jintrust Fund Management Co., said that medical infrastructure was also among the focal points of the stimulus plan. As for particular sectors, Lian Ping and Ding Guorong specifically pointed to the Central Government's 10 industry support plans as having an impact--Ding exclaimed that these plans had far exceeded the financial sector's expectations.

¶5. (SBU) Lian said that the RMB 4 trillion (approximately US$586 billion) stimulus is already having an impact. Ding similarly predicted that China's market has reached bottom, and the economy will see quarter-on-quarter rises for the next three to four quarters. At the same time, Lian said that the Central Government's contribution to the stimulus--RMB 1.18 trillion (approximately US$173 billion) over two years, or equivalent to only around 3 percent of GDP per year--does not surpass international norms; the full stimulus will be filled out by matching funding from local governments, local banks, and private investment. Lian agreed that, contrary to the views of some government officials, China could easily allow budget deficits above 3 percent of GDP, and even as high as 5 percent without raising concerns about their sustainability or China's creditworthiness.

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New Policies May Benefit Interior Cities
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¶6. (SBU) Some of the investment may be directed to central and

western China through innovative policies, explained Shanghai Financial Services Office Director General Fang Xinghai. For instance, Beijing is considering moving the headquarters of Chinese corporations to interior cities, since in theory these companies do not need to be based in the capital. Sinopec, China's leading petrochemical firm, could be headquartered in the Anhui provincial capital, Hefei. There are good prospects for domestic-led growth in Hefei, said Fang, with the urban area having doubled in recent years, but this was built on migrant worker remittances, which now may fall off.

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Shanghai Quick To Seek Support for New Investment
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¶7. (SBU) Given the emphasis on investment in the stimulus program, the Shanghai Municipal Government has been delighted to find that many major projects put on hold by the Central Government in 2007 have now been approved, said John Tan, a Shanghai-based managing director of Standard Chartered Bank. For instance, Shanghai has received the go-ahead for several previously rejected World Expo projects, as well as the Disney theme park, said Tan. In fact, Shanghai officials have called Standard Chartered to ask for project proposals, said Tan, and Fang Xinghai has asked Standard Chartered for a letter on viable projects that he can use in talks with Beijing

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Boosting Consumption Will Take Longer
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¶8. (SBU) The contribution of domestic consumption to GDP is very hard to change, admitted BoCom's Lian. The national plan to promote purchase of household electrical appliances in the countryside is one example of a program that could have an impact, said Lian. Luo Yang, PBOC Shanghai Head Office International Department Director General, acknowledged U.S. concerns that China increase domestic demand, and said that "China understands this responsibility." Wang Kaiguo, Chairman of Haitong Securities, also one of China's largest securities firms by several measures, offered a broad endorsement of the government doing more to help China's 800 million farmers who do

not have enough medical care, roads, and other infrastructure.

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Relying on Banks for Policy Support . . .
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¶9. (SBU) Several interlocutors emphasized that China's banks would support the government's economic turnaround policies, including BoCom's Lian and Raymond Yin, executive director of Beijing Gao Hua Securities Company, a joint venture with Goldman Sachs. Lian said that banks are healthy, with high capital adequacy ratios and low non-performing loans (NPLs), and thus are able to support both fiscal and monetary policy easing. Compared with the time of the Asian Financial Crisis, said Lian, the banks are better prepared. Yin commented that banks have an obligation to lend as a way of giving something back to society after years of high profits. (Comment: PBOC officials have expressed similar sentiments. End comment.)

¶10. (SBU) As a result, said Gao Hua's Yin, banks will probably face higher levels of non-performing loans in the future--and regulators are prepared to accept this. For instance, PBOC officials have told Yin that the China Bank Regulatory Commission is privately saying that it is acceptable to have a rising level of NPLs, as long as a bank's NPL ratio declines--this can be achieved simply by raising the overall level of lending. If later a slack economy causes NPLs to spike, said Yin, the CBRC has promised not to blame the banks.

¶11. (SBU) Banks are also contributing to the macroeconomic stimulus by acquiescing to lower interest rate spreads, even though this also puts their bottom line at risk, said Gao Hua's Yin. PBOC's Luo said that banks, despite excess liquidity, are still keeping the interest rate on deposits at the maximum ceiling allowed because they assume that customers will quickly switch banks if the interest rates are lowered. Banks also want to keep their level of deposits steady to maintain market share in advance of the eventual economic recovery. In addition, Luo explained, banks are helping keep the entire financial market stable by competing in terms of service quality, not through interest rates. In the early 1990s, banks offered high deposit rates to compete for customers, and the result was large losses, said Luo.

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. . . But Keeping Watch on Monetary Expansion
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¶12. (SBU) Bank lending appeared to be too high in January, said PBOC Shanghai Head Office Statistics and Research Department Deputy Director General Liu Mingzhi. However, said Luo, the PBOC cannot issue orders to the banks to rein in lending, and instead has released some public notices indicating concern. Over the next two months or so, the PBOC will collect and analyze banking sector data, said Luo, and some new policies may result. In particular, said Luo, the PBOC is tracking discounted bill lending--if this lending subsides, lending could go forward on a more stable basis. (Comment: The rise in discounted bill lending appears to be due to interest rate arbitrage. Companies can borrow through discounted bills and earn a higher interest rate in corporate CDs. Some corporate borrowers also appear to be using low interest rates on discounted bills to speculate in the stock market, accounting for its recent rise. Due to the sharp fall in interbank rates and interest paid on excess reserve, discounted bills offer banks the highest return for parking funds short-term. End comment.)

¶13. (SBU) Our interlocutors agreed that monetary authorities should remain vigilant to avoid an upsurge in inflation. PBOC's Luo said this is a major future concern, but that inflation does not look very serious for now. Nonetheless, the PBOC has carried out some open market operations in recent days to absorb liquidity. This is a signal to the market that the PBOC does

not want to see another credit fueled boom and bust cycle. BoCom's Lian Ping separately agreed, saying that the government for now is saying it wants to "stabilize" the monetary base, not "tighten" it. Lian summarized a variety of factors that could eventually lead to inflation: interest rates have dropped, required reserves have been lowered, PBOC bill issuance has been decreased, and the national credit quota has been eliminated. Lian commented that inflation has always resulted from overlending, especially in an environment of international inflation induced by substantial monetary easing.

¶14. (SBU) An additional concern brought by the monetary expansion is whether freed-up liquidity is flowing toward speculative investments, said BoCom's Lian. There are some signs that the extra liquidity is funding the run up in values of stocks, postage stamps, and gold and silver coins. Real estate has not been affected, said Lian, although real estate values are still rising to some extent. Nonetheless, concluded Lian, most of the liquidity is going to three areas: 1) large government projects, 2) less cyclical businesses, and 3) short-term funding needs--the latter explaining the rise in discounted bill lending.

¶15. (SBU) Gao Hua's Yin provided an insight into a possible policymaker perspective on the flood of liquidity into the market. He said that one of Gao Hua's advisers, Beijing

University professor Song Guoqing, is highly optimistic that the surge in the monetary base could bring 9 percent growth by the end of 2009. Yin said that Song's views may not be mainstream, but they represent the "pure monetary school" of economic policymaking.

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Many Blame the United States for the Global Financial Crisis
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¶16. (SBU) Several interlocutors emphasized that the United States was the source of the current financial crisis. Shenyin & Wanguo's Ding put it most starkly, calling it "the collapse of the U.S. 'fairy tale.'" Shanghai financial official Fang said that the global financial crisis is a result of the "profligacy of U.S. consumers," which in turn has "destroyed confidence in the U.S. dollar." Haitong's Wang said that he "used to think that the United States has the best technology and military, but not since the financial crisis started."

¶17. (SBU) But our interlocutors also held out hope that the resolution to the crisis would emanate from the United States. Fang speculated that the years ahead will be a difficult time for trade and investment, with "no anchor" for the global currency system; however, eventually the U.S. dollar will be reestabilished as the primary, but not sole, global currency. Other interlocutors offered more general comments, calling the recovery of the United States essential to world recovery (Haitong's Wang), and saying that what the United States does next in the crisis is very important, because the two sides have closer and closer ties (PBOC's Luo). Several interlocutors noted concerns that the United States is entering into even greater financial turmoil from a consumer finance induced "second wave" of the crisis. (Comment: Concern about the United States entering a "second wave" of the crisis has become increasingly prevalent in Chinese media. End comment.)

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Concerns Over Possible U.S. Protectionism
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¶18. (SBU) Several interlocutors raised concerns about the "Buy American" clauses in the U.S. economic stimulus program. The PBOC's Luo said that the United States is right to want to avoid the mistakes of the 1930s--since the United States made that mistake then. Protectionism could undermine future economic growth, said Shenyin & Wanguo's Ding, and " if there really are buy local provisions, this will be bad for China."

¶19. (SBU) At the same time, some interlocutors offered a more nuanced understanding of the political backdrop in the United States. The PBOC's Luo said he noticed that Treasury Secretary Geithner was careful to qualify his statement concerning Chinese currency manipulation by saying he was quoting President Obama. Luo also said he understood that this statement was being made to Congress, implying that he knew it was said for political purposes. Gao Hua's Yin said that there was shock when then-Treasury Secretary Paulson was reported as blaming China for the global financial crisis, but that this calmed down with Paulson's subsequent correction. "We do understand American politics, that even Obama has to be a politician," said Yin.

¶20. (SBU) Haitong Chairman Wang admitted that he thinks of the United States as a good place to invest, especially now when valuations are so low. However, his concern is whether or not Haitong could hold onto senior managers following an acquisition, given Chinese banks' lack of knowledge of U.S. culture and laws. Shenyin & Wanguo Chairman Ding also affirmed that, even though Chinese securities markets are performing relatively well, his company is interested in greater cooperation with U.S. firms.

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U.S. Banks May Find Doors Harder To Open
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¶21. (SBU) Citi China CEO Andrew Au noted that Citi is increasingly viewed as "part of the U.S. Government," which may make Chinese clients want to hold back on revealing information to Citi. Au also said that "the gap is widening" in terms of branch approvals for Citi vs. HSBC and Standard Chartered: over the past four years, Citi has had three branch approvals, while the others have had ten each. Citi's last branch approval was for Dalian, in December 2007; Citi's current Chongqing branch application and others are still under review by the PBOC. In effect, said Au, where there used to be a 50/50 split in branch approvals for European and U.S. banks, there is now closer to a 70/30 split in Europe's favor.

¶22. (SBU) Haitong's Wang offered a different comparison of U.S. and European banks. Wang said Chinese banks have been generally unsuccessful in opening branches in the United States, despite more than ten years of trying, while China itself is open. In addition, the first phrase U.S. securities firms use in negotiations with potential partners is "I'm going to eat you up," said Wang--the U.S. side demands a 49 percent share the first year, a 51 percent share the second, and 100 percent ownership the third. Singaporean and European banks, on the other hand, are less aggressive, willing to hold minority shares, and seek to start small and grow.

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Comment
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¶23. (SBU) Many of these February 19-20 Shanghai interlocutors reflected expectations that China's economic stimulus plan would be effective in reviving China's economy in advance of an anticipated 2010 rebound in global trade, but Gao Hua's Yin hit a more cautionary note. There are signs that things are getting better in the first two weeks of January, said Yin, but that is primarily because of government-supplied liquidity, and final demand is not rising. Some factories are back up and running--for instance, in steel there has been some restocking--but overall electricity demand has not rebounded. On the export side, said Yin, following the Lunar New Year multinationals have found no new orders. For instance, CIMC, the world's largest container maker, has had no orders since November, said Yin. Domestic Chinese demand appeared to have an uptick during Lunar New Year, but there was also heavy price discounting, said Yin; consumers are scaling back, taking a domestic trip rather than an international one.

¶24. (SBU) The surge in bank lending appears to have taken monetary officials by surprise and raised concerns that this will generate another credit boom and bust. As a result, it is likely that they will be more reluctant in the near term to ease monetary conditions further, despite the rise in deflation.

¶25. (U) Beijing Financial Attache David Loevinger has cleared on this cable.
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